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November 22, 1995

BY OVERNIGHT MAIL

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Mr. William F. Caton
Office of the Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: CC Docket No. 94-1

Dear Mr. Caton:

Enclosed for filing please find an original plus nine (9) copies of the Comments of Frontier Corporation in the above-docketed proceeding.

To acknowledge receipt, please affix an appropriate notation to the copy of this letter provided herewith for that purpose and return same to the undersigned in the enclosed, self-addressed envelope.

Very truly yours,

Michael J. Shortley, III

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Before the
FEDERAL COMMUNICATIONS COMMISSION
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In the Matter of	)	
	)	
Price Cap Performance Review	)	**CC Docket No. 94-1**
for Local Exchange Carriers	)	

COMMENTS OF FRONTIER CORPORATION

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November 22, 1995

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Summary

Frontier submits these comments in response to the Commission's Fourth Further Notice in this proceeding. In the Fourth Further Notice, the Commission requests comment on: (1) a variety of issues relating to the development and use of the "X-Factor" productivity adjustment; (2) the role of sharing in the Commission's price cap plan; (3) possible refinements to the common line formula; and (4) possible changes in the treatment of exogenous costs.

First, although Frontier offers no specific suggestions as to how the Commission should develop a permanent X-Factor, it suggests the following: (i) any X-Factor should meet the objectives defined by the Commission -- be economically meaningful, one that passes on productivity gains to interstate access customers, and be readily verifiable through publicly-available data; (ii) the Commission should provide for multiple X-Factors, one of which contains a no-sharing option; (iii) the rules should not constrain the ability of exchange carriers to change their selections of the X-Factor annually; (iv) the Commission should eliminate the consumer productivity dividend; and (v) the Commission should take competitive circumstances into account in applying its X-Factor and sharing rules.

Second, sharing should remain an integral part of the Commission's price cap rules. Thus, the Commission should continue to impose a sharing requirement for those exchange carriers that select relatively low productivity offsets. However, the Commission should also provide at least one no-sharing option as a reward to those exchange carriers that promise to return above-average efficiency gains to ratepayers.

Third, if the Commission adopts an X-Factor based upon a total factor productivity methodology, then the need for a separate common line formula disappears. If not, the Commission should retain the existing 50/50 common line formula.

Fourth, it seems unlikely that any X-Factor will eliminate the need for some recognition of exogenous costs. While the Commission may appropriately narrow the types of costs that qualify for exogenous treatment, it should at least ensure that -- unlike the current regime -- such rules operate symmetrically.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
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Price Cap Performance Review for Local Exchange Carriers	)	**CC Docket No. 94-1**
	)	

COMMENTS OF
FRONTIER CORPORATION

Introduction

Frontier Corporation ("Frontier") submits these comments in response to the Commission's Fourth Further Notice in this proceeding.[1] In the Fourth Further Notice, the Commission requests comment on: (1) a variety of issues relating to the development and use of the "X-Factor" productivity adjustment; (2) the role of sharing in the Commission's price cap plan; (3) possible refinements to the common line formula; and (4) possible changes in the treatment of exogenous costs.[2]

First, although Frontier offers no specific suggestions as to how the Commission should develop a permanent X-Factor, it suggests the following: (i) any X-Factor should meet the objectives defined by the Commission -- be economically meaningful, one that

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1 *Price Cap Performance Review for Local Exchange Carriers*, CC Dkt. 94-1, Fourth Further Notice of Proposed Rulemaking, FCC 94-406 (Sept. 27, 1995) ("Fourth Further Notice").

2 Frontier also responds to issues 19 and 20 set forth in the Second Further Notice. *See Price Cap Performance Review for Local Exchange Carriers*, CC Dkts. 94-1, *et al.*, Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197, FCC 95-393, ¶¶ 159-72 (Sept. 20, 1995) ("Second Further Notice"), as permitted by the Commission's recent order. *See Price Cap Performance Review for Local Exchange Carriers*, CC Dkt. 94-1, Order on Motion for Extension of Time, DA 95-2340, ¶ 3 (Com. Car. Bur. Nov. 13, 1995).

passes on productivity gains to interstate access customers, and be readily verifiable through publicly-available data; (ii) the Commission should provide for multiple X-Factors, one of which contains a no-sharing option; (iii) the rules should not constrain the ability of exchange carriers to change their selections of the X-Factor annually; (iv) the Commission should eliminate the consumer productivity dividend ("CPD"); and (v) the Commission should take competitive considerations into account in applying its X-Factor and sharing rules.

Second, sharing should remain an integral part of the Commission's price cap rules. Thus, the Commission should continue to impose a sharing requirement for those exchange carriers that select relatively low productivity offsets. However, the Commission should also provide at least one no-sharing option as a reward to those exchange carriers that promise to return above-average efficiency gains to ratepayers.

Third, if the Commission adopts an X-Factor based upon a total factor productivity ("TFP") methodology, then the need for a separate common line formula disappears. If not, the Commission should retain the existing 50/50 common line formula.

Fourth, it seems unlikely that any X-Factor will eliminate the need for some recognition of exogenous costs. While the Commission may appropriately narrow the types of costs that qualify for exogenous treatment, it should at least ensure that -- unlike the current regime -- such rules operate symmetrically.

Argument

I. THE COMMISSION SHOULD ADOPT AND APPLY RATIONAL X-FACTOR RULES.

In these comments, Frontier does not propose a specific methodology for the development of a permanent X-Factor.[3] Nonetheless, the Commission should adopt a baseline X-Factor and rules resulting in the application of that factor that are equitable to all industry participants.

A. The Commission's Articulated Goals for Developing a Permanent Baseline X-Factor Are Appropriate.

The three goals that the Commission has identified for developing the X-Factor -- that it is economically meaningful, ensures that productivity gains are passed through to ratepayers and is readily verifiable through publicly-available data[4] -- are appropriate.

The X-Factor applied must be economically meaningful -- that is, it "should provide a reliable measure of the extent to which changes in LECs' unit costs have been less than the level of inflation."[5] That is the entire purpose of the X-Factor and is critical to ensuring that exchange carrier rates reflect productivity gains expected of the industry as a whole. An arbitrarily-selected X-Factor would result in a zero-sum game, with identifiable winners

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3 Preliminarily, Frontier supports the Commission's use of the historical price-historical revenue hybrid model. *See* Fourth Further Notice, ¶ 91. This approach, for which the Commission should utilize a rolling average consisting of at least five years' worth of the most recently-available data, should produce a reasonable estimate of productivity gains achievable in the near term and ensure that real efficiency gains are returned to ratepayers.

4 *Id.*, ¶ 16.

5 *Id.*

and identifiable losers. On the other hand, an economically meaningful X-Factor and its fair application will create a positive-sum game. Access customers will benefit by realizing large, real reductions, year after year, in access rates, while exchange carriers will benefit from the opportunity to realize increased earnings above those that would be allowed under cost-of-service regulation.

An economically meaningful X-Factor will also advance the second -- and most critical -- of the goals identified by the Commission. It will ensure that interstate ratepayers benefit from reductions in exchange carriers' unit costs. One of the principal goals of price cap regulation -- articulated by the Commission since its inception -- is to replicate conditions that would exist in a fully-competitive market.[6] Efficiency gains would be reflected in prices in fully-competitive markets. Price cap regulation should attempt to achieve the same result.

Replication and verification of the data and results used to derive the X-Factor are essential. Not only would this ability ensure that any studies performed are subject to exacting public scrutiny and informed decision-making, it would also provide an administratively simple means of setting rates, thereby avoiding the inefficiencies, costs and burden of cost-of-service regulation. Ease of application is especially important in this respect if the Commission decides to utilize a rolling average to update the X-Factor.

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6 *Price Cap Performance Review for Local Exchange Carriers,* CC Dkt. 94-1, First Report and Order, FCC 95-132, ¶ 1 (April 7, 1995) ("First Report and Order").

B. Any Price Cap Plan Should Offer Multiple X-Factors, One of Which Should Contain a No-Sharing Option.

Once the Commission has established a baseline X-Factor -- representing the average expected productivity gains of the exchange carrier industry[7] -- it should then continue to offer one or more additional, more challenging options, each accompanied by successively less restrictive earnings constraints. Although the Commission is correct that sharing blunts the full efficiency incentives of price caps, there is an offsetting consideration. With no options not involving sharing available, the resulting incentive structure would induce exchange carriers to select the lowest -- or baseline -- offset. Such a system would produce no benefits to ratepayers that would not otherwise exist under cost-of-service regulation.

Because the baseline X-Factor represents -- and should represent -- the *average* expected industry productivity gain -- eliminating sharing entirely would reward merely average performance. To avoid this undesirable result, the Commission should continue to apply a price cap system that rewards risk and above-average performance. A system

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[7] Based upon an *ex parte* communication by the Ad Hoc Telecommunications Users Committee ("Ad Hoc"), the Commission has requested comment on whether to include other telecommunications services providers -- such as interexchange carriers and competitive access providers -- in the equation for establishing the X-Factor. Fourth Further Notice, ¶¶ 73-74. The Commission should decline to adopt this idea. The purpose of establishing the baseline X-Factor is to determine the average expected productivity of the exchange carrier industry. Including other market participants -- that may have widely different operating characteristics -- would skew the results of any productivity study. Nor would their exclusion provide "gold-plating" incentives. Regardless of the level of the productivity offset, an individual exchange carrier could always improve its own earnings performance by increasing its efficiency. Thus, for there to be any validity to Ad Hoc's assertion, collusion would be necessary. That type of behavior -- particularly with regard to decisions such as network investment -- is virtually impossible.

of multiple X-Factors -- coupled with successively less stringent earning constraints, including a no-sharing option -- will achieve this result.

C. The Commission Should Not Change the Ability of Exchange Carriers To Elect an X-Factor Annually.

The Commission posits that the current rules -- which permits exchange carriers annually to elect the X-Factor -- provides an opportunity to game the system.[8] However, the current experience under price caps does not indicate that such gaming has occurred and the Commission points to no evidence to the contrary. As such, there is no basis for the Commission to change the current system.

The Commission should also decline to adopt its proposal to classify exchange carriers, on a mandatory basis, into one X-Factor category or another -- either directly or though presumption.[9] As the Commission correctly notes,[10] there is no obvious basis on which to make such an assignment. Nor is any criterion obvious. Size doesn't' work. Some of the nation's largest exchange carriers -- *e.g.*, Ameritech and Bell Atlantic -- have been in the 100% sharing range; so, however, have the smallest -- Frontier's 2 Tier exchange carrier subsidiaries. At the same time, large and smaller price cap carriers -- *e.g.*, NYNEX and SNET -- have invoked the lower formula adjustment. As the above also demonstrates, geography played no role in performance. The above strongly suggests

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8 Fourth Further Notice, ¶¶ 121-23.

9 *Id.*, ¶¶ 124-26.

10 *Id.*, ¶ 124.

that a mandatory assignment system could not be rationally developed. Attempting to develop and apply one -- or even applying a system that created a presumption that the highest offset would apply unless a particular exchange carrier demonstrated special circumstances warranting differential treatment[11] -- would constitute no more than a waste of time, money and resources.

D. The Commission Should Eliminate the Consumer Productivity Dividend.

The CPD was initially designed to prompt exchange carriers to squeeze out the last remaining inefficiencies that of cost-of-service regulation had embedded in exchange carriers' rates.[12] That process has come to an end.[13] Moreover, if the Commission selects an appropriate baseline X-Factor -- and provides more challenging X-Factors that offer greater earnings relief -- it may expect exchange carriers, in the aggregate, to elect higher than baseline X-Factors. That incentive structure itself would render the CPD unnecessary.

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11 *Id.*, ¶ 125.

12 *See Policy and Rules Concerning Rates for Dominant Carriers,* CC Dkt. 87-313, Further Notice of Proposed Rulemaking, 3 FCC Rcd. 3195, 3407-08, ¶ 386 (1988).

13 *Bell Atlantic v. FCC*, No. 95-1217, Brief for the Performance Review Petitioners and Intervenors in Support Thereof at 30-31 (D.C. Cir, filed Sept. 13, 1995).

E. The Commission Should Take Competitive Considerations into Account in Applying Its X-Factor and Sharing Rules.

The Commission inquires as to whether it should adjust its X-Factor levels and its sharing levels as an inducement for additional pricing flexibility.[14] It also asks whether it should adjust its sharing requirements to account for competitive conditions, as proposed by NYNEX.[15] The Commission should not adopt the first proposal; it should, however, adopt the second.

Increased pricing flexibility should be accorded an exchange carrier based only upon competitive conditions. The X-Factor level has no bearing on this issue. It should reflect anticipated productivity gains.[16] Pricing flexibility should not be held out as a carrot to induce the selection of a higher productivity offset. An exchange carrier with closed or near-closed markets should not be rewarded with increased pricing flexibility -- that could be used to *foreclose* competition -- for choosing a higher offset the achievement of which may well be made possible by potential anticompetitive activities. The proposal is a *non sequitur* to which the Commission should devote no further attention.

The Commission, however, should take competitive considerations into account in applying its X-Factor and sharing rules. A major reason that exchange carriers have

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14 Second Further Notice, ¶¶ 159-62.

15 *Id.*, ¶¶ 163-72.

16 *Nat'l Rural Telecom. Ass'n v. FCC*, 988 F.2d 174, 183 (D.C. Cir. 1993).

experienced greater than average productivity is that their operations are characterized by high fixed costs and economies of scale. As exchange carriers lose market share to new entrants, their ability to realize economies of scale will diminish, thereby resulting in lower achievable productivity gains. The Commission should take this circumstance into account in establishing and applying an X-Factor and in determining its sharing rules.

II. SHARING SHOULD REMAIN AN INTEGRAL COMPONENT OF PRICE CAP REGULATION.

The Commission should continue to design its price cap plan to reward performance. On this basis alone, the baseline X-Factor -- which should reflect *average* industry performance -- should carry with it average reward. That necessarily carries with it a sharing obligation. To the extent that an exchange carrier commits only to average performance, the earning that the regulations allow it to retain should also only be average. This principle necessarily means that its earnings must be constrained near the prescribed rate of return. Thus, the existing sharing rules at the 4.0% X-Factor should apply to any baseline X-Factor that the Commission selects.

The obvious corollaries also apply. An exchange carrier that commits to returning to ratepayers efficiency gains well above average should be rewarded commensurately. A sufficiently aggressive spread -- *i.e.*, up to 150 basis points above the baseline X-Factor -- should be rewarded by a no-sharing option. This option would provide exchange carriers with a means of returning to ratepayers efficiency gains substantially in excess of the industry average in exchange for the *expectation* that they may realize increased earnings. Such an approach represents a classic positive-sum game.

The latter corollary also applies, and suggests the elimination of the lower formula adjustment. The existing, "automatic pilot" for below-average performance should not be retained. That is, the rules should not reward unacceptable performance. The lower formula adjustment, however, does precisely that. It provides a guaranteed cushion for substandard performance -- a result that, at the least, is not consistent with the goals of price cap regulation.[17] The lower formula adjustment significantly dulls price cap incentives and the Commission should eliminate it from its price cap regime.

III. CHANGES IN THE COMMON LINE FORMULA DEPEND UPON THE METHODOLOGY ADOPTED BY THE COMMISSION.

As the Commission correctly notes,[18] if it adopts a TFP methodology for determining an X-Factor, then the current common line formula would double-count demand growth. It would be counted both in the development of the X-Factor and in the application of the X-Factor to the common line basket.

On the other hand, if the Commission adopts another basis for calculating the X-Factor, it should adopt a common line formula that is not based solely upon growth in access lines. The current 50/50 common line formula produces a rational compromise.

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17 The result proposed herein is not particularly harsh. An exchange carrier that earns well below the prescribed rate of return may file an above-cap rate filing . Thus, recourse is not unavailable; what *is* unavailable is *automatic* recourse.

18 Fourth Further Notice, ¶ 134.

The Commission's tentative conclusion -- that exchange carriers have little influence over usage of common line facilities[19] -- is not entirely correct. The major factor driving long distance prices lower over the past ten years, and therefore growth in minutes of use, has been access charge reductions. Thus, the level of access rates has a significant influence on common line usage. The 50/50 common line formula recognizes this linkage. A pure, per-line common line formula would not.

IV. THE COMMISSION SHOULD ADOPT A BALANCED APPROACH TO THE TREATMENT OF EXOGENOUS COSTS.

The Commission posits that it may be able to develop an X-Factor methodology that would render any exogenous cost treatment unnecessary.[20] Frontier does not share the Commission's optimism. There will likely be certain changes that are beyond exchange carriers' control, do not affect productivity, and yet, have a profound effect on interstate revenue requirement. Even MCI recognizes that changes in the Part 36 separations rules represent one such category.[21] Thus, it seems apparent that the price cap rules will need to address the issue of exogenous costs in some fashion.

Therefore, the Commission must adopt a balanced approach to the treatment of similar cost changes -- either endogenously or exogenously. The current rules do not achieve this equitable balance. Cost changes that force rates down -- *e.g.*, expirations of

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[19] First Report and Order, ¶¶ 268-69.

[20] Fourth Further Notice, ¶ 138.

[21] *Id.*, ¶ 141.

reserve deficiency amortizations -- are treated exogenously, while cost changes with identical economic effects that would otherwise raise rates -- *e.g.*, adoption of Statement of Financial Accounting Standard 106 -- are denied exogenous treatment. Both are pure changes in accounting costs with no underlying economic effect. That is, neither cost change affects cash flow. Nonetheless, they are accorded exactly the opposite treatment.

Whatever the merits of the Commission's newly-articulated "economic cost" standard,[22] the Commission should at least conform its rules to apply that standard on a consistent and unbiased basis.

Conclusion

For the foregoing reasons, the Commission should act upon the proposals contained in the Fourth Further Notice in the manner suggested herein.

Respectfully submitted,

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November 22, 1995

22 First Report and Order, ¶ 294.

Certificate of Service

I hereby certify that, on this 22d day of November, 1995, copies of the foregoing Comments of Frontier Corporation were served by first-class mail, postage prepaid, upon the parties on the attached service list.

Michael J. Shortley, III

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CC DOCKET NO. 94-1 - PRICE CAP PERFORMANCE REVIEW FOR LOCAL EXCHANGE CARRIERS

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